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Contagion concern not apparent in stress indicators – yet

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While the ongoing "Greek tragedy" has had markets transfixed for weeks now, the prospects about a potential "contagion" effect are not apparent in stress indicators. At least, not yet.

Contagion refers to a situation whereby concerns about a possible negative event – a debt default by Greece, in this instance – spills over to other (indebted) nations, triggering a global sell-off in multiple asset classes. Contagion is a phenomenon that central banks will always try their utmost to avoid, because they can trigger long-lasting, global financial crises.

We need look no further than the 2008 global credit crunch for an example of contagion and the devastation that can be wrought by a worldwide financial crisis. In fact, the concerns that have been simmering for more than a year now about the heavy debt loads of a number of European nations (Portugal, Italy, Ireland, Greece and Spain – or PIIGS in short) are a direct offshoot of the 2008 credit crunch. The Asian crisis of 1997 and the Russian debt crisis of 1998 are other notable instances of contagion in recent decades.

Global equity markets have been steadily factoring in the renewed sense of uncertainty caused by the European debt situation, with most major equity indexes down anywhere from 4% to 10% so far in Q2. But surprisingly, the decline has been quite orderly, with few concerns about contagion apparent in widely-watched stress indicators (see Charts on next page).

The CBOE Volatility index or the VIX has been largely range-bound between 15 and 20 over the preceding three months, and has only been breaking through the upper end of that range since June 15. The TED Spread (which, because it measures the difference between three-month LIBOR and three-month US T-bills, is a good indicator of stress in the credit markets) is currently at 24 basis points – it had spiked to a record 4.63% in October 2008 at the height of the crisis. Our proprietary FAIL® indicator – which combines the VIX and TED Spread to provide a composite measure of concern about global systemic failure – has risen in recent weeks to about 1.60 presently, but is still well below the level of 3.00 that would indicate elevated concerns about "Financial Armageddon." About the only indicator that shows signs of mild panic is the level of the Put-Call Ratio (PCR) on the CBOE, which this month traded above the pivotal 1.0 level for the first time since this rally commenced in March 2009.

So are these stress indicators poised to surge, as they were back in August 2007, or are they likely to remain range-bound? Much of course depends on how the European debt issue – beginning with Greece – plays out. Our sense is that while significant increases in these stress indicators certainly cannot be ruled out, we are unlikely to see anything like the huge spikes witnessed in 2008. Unless the current situation is in danger of morphing into the second act of the 2008 credit crisis, which we really doubt at this stage.

The optimistic viewpoint is that the markets may be poised to rally in the weeks ahead if the Greece debt issue is resolved favourably, and the markets view such a resolution as a template to tackle the debt woes of the other PIIGS. Another major condition for a market rally is positive incoming economic data from the US, which is required to boost the case for a rebound in the economy from its current soft patch.

Bottom-Line: Expect the current bout of uncertainty to last at least through the first half of summer, unless we see a speedy resolution to the European debt imbroglio.

Near-term dates to watch are June 30, when Greek lawmakers will vote on an austerity package that was unveiled yesterday. Measures in the package announced yesterday by Greece's finance minister included a 5% tax on lawmakers' income, a levy on self-employed professionals and a reduction in the tax-free income allowance. Between July 15 and July 22, Bloomberg estimates that the nation needs to cover about EUR 4 billion of bills maturing during those dates, with another EUR 3 billion of coupon payments also due in July. The beleaguered nation also has to redeem EUR 6.6 billion of bonds on August 20.

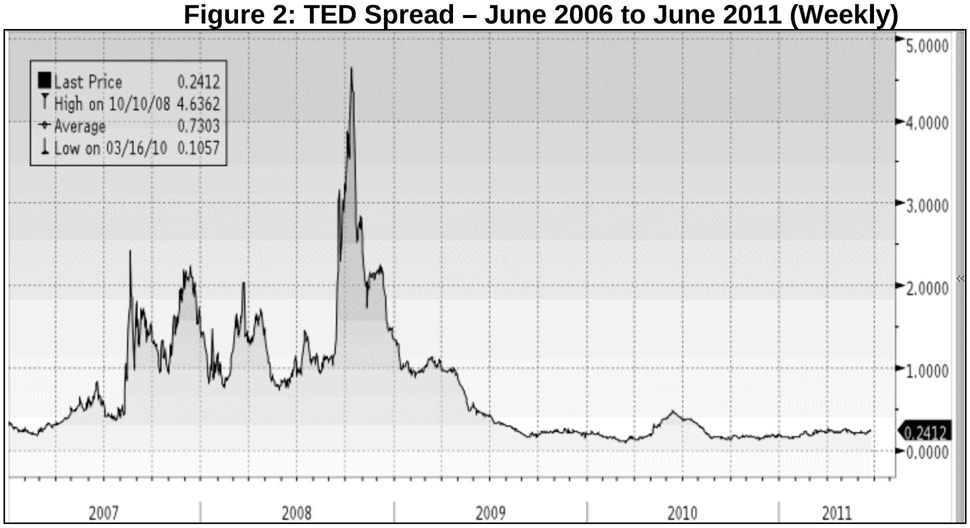
Given those mounting liabilities, we believe that the odds are that EU leaders will push an aid package through sooner rather than later. The alternative – a default by Greece, which would put at stake the future viability of the European Union and euro itself – is simply unthinkable.

From an investment perspective, we suggest accumulating or adding in a measured manner positions in large-cap energy producers and mid to large-cap gold producers, many of which are at attractive valuations after their recent sell-off. While we do not suggest adding aggressively to positions yet, we remain optimistic that this sell-off will turn into a classic buying opportunity over the next month or too.

Figure 1: VIX – June 2006 to June 2011 (Weekly)

Source: Bloomberg

Figure 2: TED Spread – June 2006 to June 2011 (Weekly)



Source: Bloomberg

Figure 3: FAIL® vs. S&P 500 and MSCI World – June 2006 to June 2011 (Weekly)

Source: Global Securities Research, Bloomberg

(Trade Update) Aecon Group - Reiterate Buy with $12 target

Aecon Group (TSX: ARE, $8.14) gapped higher today, presumably driven by a rating and price target reiteration by Canaccord Genuity analyst Yuri Lynk, who has a Buy rating with a $13 price target on the stock.

Aecon has drifted lower recently, as the infrastructure sector has been affected by dismal results from Armtec Infrastructure (TSX: ARF, $3.85) earlier this month. However, analysts' EPS estimates for Aecon have not changed much since our May 13 update on the stock. Average EPS estimates for 2011 are currently at $0.44 (down 5% from $0.47 in our previous update), more than doubling to $0.92 (up 2% since our update) in 2012. While Aecon continues to appear expensive on the basis of this year's earnings estimates, trading at 18.1x FY11 forecast EPS, it looks cheap on the basis of its forward single-digit P/E, trading at 8.9x FY12 forecast EPS.

The forecast earnings jump for next year implies that analysts' believe management's contention that its recent problems have been transitory in nature. However, Aecon investors will need to be in for the long haul, as the stock is unlikely to get the benefit of the doubt until it demonstrates renewed earnings growth. We reiterate our Buy rating on Aecon, with a target price of $12. The stock currently has a dividend yield of 2.4% (based on a quarterly dividend of 5 cents).

Market Snapshot at Close

S&P TSX	12908.89	-70.69	**Commodities**			**Yields (%)**	**Can.**	**US**
TSX Venture	1905.33	-9.55	Canadian $	1.0130	-0.0086	90 Day T-Bill	0.73	0.01
DJIA	11934.58	-115.42	Gold (Spot)-US$	1502.15	-19.25	2-Year Bond	1.38	0.33
S&P 500	1268.45	-15.05	Oil (WTI-Aug.)	91.11	+0.09	10-Yr.Bond	2.86	2.87
NASDAQ	2652.89	-33.86	CRB Index	329.89	-0.32	30-Yr. Bond	3.36	4.19

Thought for the Day

"Look for an impending crash in the economy when the best seller lists are filled with books on business strategies and quick-fix management ideas." – Peter Drucker